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Portfolio insurance's merits spur debate

By Trudy Ring

New York - Pension funds that use portfolio insurance might be sacrificing returns and focusing on short-term goals, said Bruce I. Jacobs, senior managing director of Eagle Rock Asset Management, Newark, N.J.

Not so, said John W. O'Brien, chairman and chief executive officer of LeLand O'Brien Rubinstein Associates Inc., Los Angeles. Buyers of portfolio insurance are long-term investors and will receive better long-term performance than those with uninsured portfolios, he said.

Messrs. Jacobs and O'Brien debated the merits of portfolio insurance at "Innovative Portfolio Insurance Techniques," a conference sponsored here in June by the Institute for International Research.

Portfolio insurance, also known as dynamic hedging, is a strategy aimed at achieving a prespecified minimum return and permitting capture of gains without market forecasting. Generally, it is implemented through selling stock index futures when the protected portfolio's value declines.

Mr. Jacobs said users of portfolio insurance are reacting to short-term blips that generally are of little consequence. "Pension plan liabilities are long run in nature," he said. "Long run strategies should be adopted.

"Some of us are concerned with wealth accumulation. Why not select a strategy that will maximize the growth rate of the portfolio?"

Mr. O'Brien, whose firm is one of the largest vendors of portfolio insurance, responded, "We don't advocate short-term strategies. We believe in strategies that are attuned to how people perceive risk."

Mr. Jacobs said that in advertising portfolio insurance, vendors often pick periods of poor stock performance to show how much better insured strategies would have done. Naturally, if a fund manager looks at a 10-year period of poor stock performance, he will believe he is better off with insurance, Mr. Jacobs said. "If your home burned down, you're richer because you insured," he said.

Noting portfolio insurance is touted as a means of locking up gains, Mr. Jacobs added, "If one chooses to lock in gains today, one may be locking out gains tomorrow."

But Mr. O'Brien said a study by Hayne Leland, LOR managing director, indicated that for the 55 years ending in 1982, an insured strategy would have outperformed an uninsured strategy by more than 100 basis points a year, even after transaction costs.

Mr. Jacobs contended that for any insured strategy, an uninsured, constant asset mix strategy with the same standard deviation as the insured strategy would perform better.

Mr. Jacobs said another fault he finds with portfolio insurance is the premiums it can require. He said portfolio insurance actually might not be in the best interest of shareholders.

"Career insurance for the pension officer and performance insurance for the money manager are other factors that may come into play," he said.

Mr. O'Brien replied, " Looking at premiums is kind of like the accountant who knows the price of everything and the value of nothing. Real people need to look at real alternatives."

Portfolio insurance is valuable because it can control potential shortfalls in pension assets and assure a minimum rate of return, Mr. O'Brien said. Pension officers seem to have a lessening interest in performance and a growing interest in financial control, he said. "Until recently, pension assets floated on the sea of the market," he said.

He did acknowledge not everyone can implement portfolio insurance, as the users of it have to have trading partners. That granted, he said 50% of the institutional market can buy portfolio insurance, with the other half of the market on the other side of the trades.

(Another speaker at the conference, R. Steven Wunsch, vice president of Kidder Peabody & Co., New York, suggested everyone in the market could be both buyers and sellers of portfolio insurance, with buying and selling coming at alternative times.)

To date, only about 2% of the institutional market is using portfolio insurance, Mr. O'Brien said.

Mr. Jacobs said he does see some applications for portfolio insurance, such as for pension funds sponsored by financially distressed companies that have a clear need for a prespecified level of downside protection. "Portfolio insurance is not a panacea for pension plans, but there will be instances where it is a sensible strategy," he said.